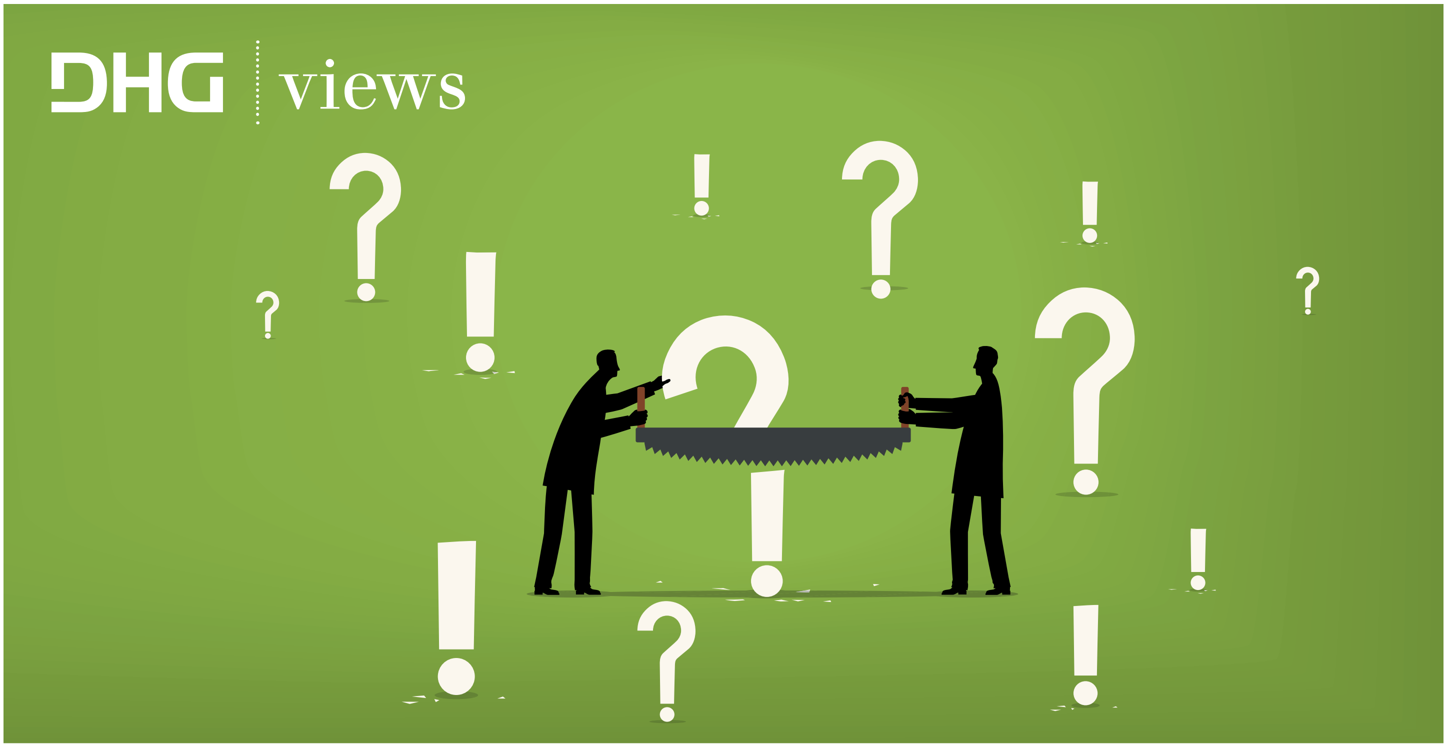

LIBOR Transition to SOFR

LIBOR has been an integral part of the global financial system for decades. Due to its ubiquitous nature, transitioning to alternative reference rates will need careful consideration to limit adverse impacts to the global economy. Regulators, industry working groups and market participants are invested in a synchronized and timely execution of this mandate. Impacts will be felt at all levels of financial institutions, and senior leaders will need to act in these organizations to ensure that effective working groups are assembled to tackle the issues at hand. A call to action has been made, and urgency is needed to accelerate the timeline surrounding LIBOR transformation in preparation for the decommissioning of LIBOR at the end of 2021.

Background

While we know global markets are retreating from the use of the London Inter-bank Offered Rate (LIBOR), the means of transition to a new standard rate is far from clear for the financial services industry. In 2018, the Financial Conduct Authority (FCA) announced that banks will no longer be required to provide inputs for the calculation of LIBOR. Following this announcement, the Federal Reserve's working group, known as the Alternative Reference Rate Committee (ARRC), identified the Secured Overnight Financing Rate (SOFR) as the frontrunner to replace U.S. Dollar (USD) LIBOR rates domestically. The Federal Reserve Board, International Swaps and Derivatives Association (ISDA), and other regulatory oversight bodies are proactively monitoring transition plans. The inevitable transition away from LIBOR has raised concerns and spawned challenges for banks; this paper will explore these challenges in greater detail and outline an approach that will help banks to limit transition risks and create synergies across their cross-functional teams.

Rate Alternatives and Industry Outlook

SOFR, an overnight rate based on Treasury repurchase agreement transactions, has been recommended and promoted as the preferred rate to replace LIBOR in the U.S. by the ARRC. Consisting of private-market participants, including past LIBOR contributing banks, the ARRC has identified SOFR as a robust alternative. SOFR succeeds in several areas underlined in the International Organization of Securities Commissions (IOSCO) Principles for Financial Benchmarks where LIBOR failed (i.e. governance, conflicts of interest)[1].

It has been over a year since the Federal Reserve initially published SOFR. Coinciding with market confidence, acceptance of SOFR is steadily growing as the new rate is utilized by more banks and lenders. The CME Group estimates SOFR's calculation to be based on over $1 trillion in overnight Treasury repo transactions[2].

Regulatory and industry working group progress is accelerating. ISDA issued their final consultation on fallback language, and the ARRC released their latest newsletter highlighting a new checklist on how to implement the transition. The Financial Accounting Standards Board (FASB) issued a new proposal around fallback language to mitigate any fallout from the transition relating to contract modification and hedge accounting. These updates will still require cooperation from the financial services industry in applying fallback language in a prompt and coordinated manner across financial market participants.

Many institutions face SOFR transition challenges stemming from the uncertainty around regulatory, operational and systemic impacts to the financial markets. Despite these uncertainties, market participants continue to make positive advances.

Challenges, Current Issues and Key Considerations

Due to the prevalence of LIBOR-linked instruments in the global markets, financial institutions face wide-ranging impacts to their operations. Cross-functional workstreams within global banks face several unique challenges that influence how banks will interact with clients, counterparties and other stakeholders.

Figure 1

The industry is reaching a critical point in the LIBOR transformation timeline. Banks are formalizing transition plans, and industry working groups are setting the standards for fallback language that will guide financial markets closer to ending the reliance on LIBOR. Current uncertainty around term structure creation, fallback language and company exposures to LIBOR are obstacles for many global bank's program management offices to define the scope of LIBOR replacement. Below we lay out some functional workstreams and key considerations that help guide financial institutions to make more informed and effective implementation decisions.

I. Legal, Risk and Compliance

With banking being a highly regulated industry, the need for proper controls around SOFR implementation have knock-on effects through several different workstreams. The change from LIBOR will impact ISDA Master Agreements and their components, such as credit support annexes (CSA). Considerable legal resources will be needed throughout the transition process to facilitate institutions through contract negotiations, fall back language adoption and risk mitigation. Restructuring CSAs for adjusted fallback language poses significant issues such as identifying which contracts are in scope and understanding the varying degrees of complexity in fallback language that will need to be addressed. This highlights the need for artificial intelligence to automate a time-consuming and potentially risky task. For these automation tools to be implemented, digitizing records will be imperative to create a comprehensive catalogue of impacted contracts.

A proper enterprise risk framework is necessary to implement the updates to various systems and models. It is critical to identify the risks that banks are facing so they can be properly managed. Many institutions are facing challenges stemming from the volume and granularity at which contracts tied to LIBOR need to be reported. Pricing, risk and stress models will need to be properly validated and tested to mitigate market and credit risk. Managing the internal risks banks face is imperative to prevent reputational risk that may cost banks billions of dollars in fines and litigation expenses. Regulators in the U.S. are starting to place emphasis on the importance of appropriate customer education and disclosures. Regulators and industry groups (including the Securities Industry and Financial Markets Association (SIFMA) and the FRB) include language in their LIBOR transition checklists to highlight this important step for financial markets participants[3].

II. Regulatory and Industry Outreach

The regulatory impact of replacing LIBOR will require banks to focus considerable effort on communications with national working groups, regulators and industry groups through regulatory responses and participation in industry group consultations. Banks that have started a proactive dialogue with regulators and industry groups have a better understanding of the scope and transition.

The New York State Department of Financial Services (NY DFS) are requiring financial services companies to deliver each organization's LIBOR Transition to mitigate risks resulting from the transition[4]. These types of requests demonstrate the sense of urgency expected for banks in developing and implementing their strategies for adapting to new Alternative Reference Rates (ARRs). In addition to domestic regulator and industry group involvement, open communication with all national working groups allow banks to better align their global LIBOR transition strategy. It is essential for banks to understand cross-border and domestic implications to increase global banks' abilities to mitigate risk and add value for each market participant.

III. Internal and External Communications

Effective communication will be necessary to drive adoption of SOFR for banks throughout the financial markets. Internal communications need to be standardized and driven by senior management to establish a cohesive message to employees. Senior management needs to be an advocate of change to drive adoption across the company. Different stakeholders throughout the bank will need to be educated on the transition including how it affects their role and any impact it may have on counterparties or clients. This internal education should showcase the need to identify all impacted clients and develop a proactive communication and client outreach plan. Internal education efforts must be constructed in the context of external communication plans to ensure appropriate readiness as client inquiries increase.

Creating a detailed external client communications strategy will have a direct impact on risks that banks face, including conduct and regulatory risk, but may also impact the profitability of banks resulting from LIBOR transition. A plan that is differentiated by both product and client type will aid in the initial execution of client communication focused on education and future impacts of fallback language execution. Establishing open lines of communication from the outset will aid in bilateral or multilateral contract negotiation.

IV. Treasury, Tax and Accounting

The potential tax implications for banks are a source of concern for the industry. Standard setting bodies are working diligently with the industry to facilitate a smooth transition. By changing the underlying reference rate on billions of dollars in derivative notional and cash market instruments, financial reporting on multiple bank functions will be impacted. Disclosures on the financial reports like the 10-K will need to be updated to show new risks posed to investors arising from the switch to SOFR[5].

Taxation impacts hedge accounting on multiple fronts. Currently, for cash flow hedges to be effective, there should be predictable cash flows. However, cash flows based on LIBOR will be replaced by those based on SOFR. This poses a significant issue for tax planning. Research may also be required as to whether the change to SOFR qualifies as a deemed taxable exchange for derivatives used in hedge accounting. Realizing previously deferred capital gains or losses held in Other Comprehensive Income pose significant risk to banks. Price testing will also need to be revised to implement the new interest rate curves. At this point, term rates are unavailable, making it difficult to value instruments in the event of a sudden move away from LIBOR.

With fallback language yet to be adopted, many dependent steps are in flux. This has a significant impact on many treasury functions, including bank funding, liquidity risk and funds transfer pricing. Banks are unable to issue long-term debt due to the lack of a term structure that incorporates proper funding costs. This problem is further accentuated by the exposed basis risk when hedging contracts are based on SOFR, which essentially creates a risk-free curve. This mismatch in turn creates volatility in earnings which directly impacts regulatory capital.

V. Technology and Operations

The establishment of a proper technology infrastructure is key for a smooth transition to SOFR. Most large banks will have multiple technology systems within individual lines of businesses that need updating and testing. Banks will need to update operational systems across front, middle and back office as well as train in-scope staff. With the tight deadline of end of year 2021, banks will need to properly fund and staff the program office in order to properly administer the technology workstreams necessary for a successful and timely transition. Banks need to consider a phased rollout approach for product and technology changes to ensure they are in line with market trends. New products and existing positions will need to be tested and implemented for SOFR in conjunction with instituting changes related to systems that will be used to analyze and report on these changes. Updating bank operations will be imperative to ensure processes will be revised to incorporate the new reference rate as well as staff being educated on how to implement the new changes. Banks will also need to establish proper procedures to implement regulatory and SEC reporting.

VI. Lines of Business

The key considerations addressed above are woven through all lines of business (LOB) making it essential for banks to focus their efforts on communicating LIBOR Transition strategy throughout all areas within the bank.

Similar considerations can be paid to various LOB's. Retail and wealth management companies may face issues regarding conduct risk and customer education to prevent any avoidable legal issues. Capital markets and commercial banking will both be subject to pricing model changes as well as risk associated with the delay in the establishment of a term structure for SOFR. Remediation by product type should be appropriately prioritized and those products not reliant on a term structure can be completed in 2020. Risks and readiness efforts will evolve across 2020 and 2021 as additional industry guidance should provide more clarity and against all risks (AAR) policies mature.

A Limited Transition Timeframe

The finalized fallback language is progressing according to the ARRC Paced Transition Plan as shown below in Figure 2. The ISDA is now in the final stages of fallback language confirmation for derivatives, but the ARRC is still working on fallbacks for cash products. There is an effort to make the fallback language as consistent as possible to facilitate a seamless transition to SOFR. Establishing a SOFR term structure will further enhance adoption.

Figure 2

TIMEFRAME	
2019	Fallback Language Finalized: ARRC and ISOA attempting to finalize fallback language for derivatives and cash market instrument
2020	Team Structure: Creation of term structure tied to SOFR
	SOFR Futures: LCH moves PAI/Discounting to SOFR
2021	CCP's: No longer accepting new contracts with effective Fed Funds Rate for PAI/Discounting
	Transition away from IBOR: IBOR cease to be published

The establishment of LIBOR transformation teams in large banks is becoming commonplace. It is critical for banks to start the process of identifying their exposure to LIBOR and assessing their different lines of businesses to determine the overall impact. Most importantly, banks' executive leadership teams need to provide sponsorship, guidance and timely decision-making.

DHG's Approach to Transition

Regulators have recently reiterated their commitment to LIBOR replacement and encouraged banks to accelerate transition activities. As this is an unprecedented change within the industry, many banks are unsure of where to start with transition planning or how to meet the requirements. DHG has the experience, knowledge and leadership to help clients through this change. DHG understands the urgency of LIBOR transition activities and is prepared to help banks navigate the implementation process. DHG has a streamlined LIBOR transition approach as highlighted below which enables an efficient path forward to transition away from LIBOR.

Figure 3

IMPACT ASSESSMENT

- Business and control function review
- Quantitative analytics assessment
- Product scope identification and exposure measurement
- Balance sheet assessment
- Accounting and tax implications
- Technology and operations

ANALYSIS AND TEAM STRUCTURE

- Establish program management office, steering council and governance routines
- Analyze contract inventory / population completeness, contract language and existing fallback
- Assess operational, liquidity, credit and market risk implications
- Customer communication planning
- Industry forum engagement

PRODUCT AND CLIENT TRANSITION PLANNING

- Cash product transition plan
- Derivative product transition plan
- Contract re-negotiation and re-papering approach
- New product design and implementation
- Internal communication and training

TREASURY, FINANCE AND RISK PROCESSES

- Asset / liability management and hedging
- Long-term debt
- Tax and accounting changes
- Funds transfer pricing
- Risk models

TECHNOLOGY / OPERATIONS

- Technology infrastructure / systems changes for front, middle and back office
- Operational process changes
- Establish controls
- Reporting changes

DHG has extensive knowledge and experience in large-scale transformation advisory and is prepared to help our clients manage this significant change in the financial services industry. For additional information, please contact one of our LIBOR Transformation Leaders below.

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Footnotes

1. Principles for Financial Benchmarks (July 2013). https://www.iosco.org/library/pubdocs/pdf/IOSCOPD415.pdf

2. SOFR: A Year in Review (April 2019. https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/SOFR_Anniversary.pdf

3. Practical Implementation Checklist for SOFR Adoption: https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/ARRC-SOFR-Checklist-20190919.pdf

SIFMA Insights: Secured Overnight Financing Rate (SOFR) Primer The transition away from LIBOR: https://www.sifma.org/wp-content/uploads/2019/07/SIFMA-Insights-SOFR-Primer.pdf

4. Industry Letter: Request for Assurance of Preparedness for LIBOR Transition: https://www.dfs.ny.gov/system/files/documents/2019/12/il191223_libor_letter.pdf

5. Staff Statement on LIBOR Transition: https://www.sec.gov/news/public-statement/libor-transition#_ftn22